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ABSTRACT

This manual is intended to introduce attorneys to the concept of home equity conversion (HEC) so that they can knowledgeably advise elderly homeowners who may be considering this type of transaction. It is directed to attorneys representing the elderly rather than to attorneys representing lenders or investors in home equity conversion transactions. The introduction explains that all HEC plans convert an elderly person's home equity into a liquid asset and enable the homeowner to continue living in the home without regular loan repayments. It is noted that HEC liquifies all or a portion of the equity in the home; entails costs to the homeowner in the form of transaction costs, interest, or foregone appreciation; and involves some risk for both homeowners and lenders. Overall considerations in counseling are discussed and attorneys are advised to conduct a cost-benefit analysis over the expected life of the client. The three most common methods of HEC (reverse mortgage loans, sale-leasebacks, and sale of remainder interests) are described and significant issues related to each method are raised. One section focuses specifically on how the various forms of home equity conversion would affect a Supplemental Security Income recipient. The final section recommends that, before making a decision about home equity conversion, elderly homeowners should consider all alternatives available to them. Some of these alternatives are briefly discussed. (NB)

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Advising Older Homeowners on Home Equity Conversion:

A Guide for Attorneys

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Advising Older Homeowners on Home Equity Conversion:

A Guide for Attorneys

by
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and
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Consumer Affairs • Program Department

American Association of Retired Persons

AARP

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Foreword

The American Association of Retired Persons (AARP) has, for several years, taken a position in support of the concept of home equity conversion as a viable option for older homeowners who wish to remain in their homes and supplement their income. Experience indicates that the homeowner most likely to take advantage of this option is age 70 or older, female, single, and living on a limited income, with few other assets. The potential benefits to these homeowners are substantial. Besides enabling homeowners to remain in familiar surroundings, home equity conversion can provide resources for discretionary use in undertaking home repairs and in financing in-home health care or services.

One of the biggest stumbling blocks in the development of home equity conversion mechanisms is the dearth of available plans. At this time, only a handful of plans are available in scattered communities across the country. Another significant problem for older homeowners who have a home equity conversion plan available to them is finding professional advisors who are familiar enough with the concept to be able to give sound advice in this area.

In response to these problems, AARP's Consumer Affairs Section has prepared manuals on home equity conversion for attorneys, bankers, and financial advisors. The manuals are designed to provide basic information on home equity conversion, highlighting some of the critical issues that should be understood and addressed in advising an older client. AARP has sought the assistance of persons with expertise in each particular field: banking, law and financial planning, to write each manual respectively. The information is presented as objectively as possible and does not necessarily represent the Association's policies. All of the manuals are available at no charge from:

Consumer Affairs Section
American Association of Retired Persons
1909 K Streeet, N.W.
Washington, DC 20049

Introduction

This manual is intended to introduce attorneys to the concept of home equity conversion so that they can knowledgeably advise elderly homeowners who may be considering this type of transaction. Home equity conversion is a general term applied to a variety of transactions, all of which have two common elements: (1) they convert an elderly homeowner's home equity into a liquid asset, and (2) they enable the homeowner to continue living in the home without regular loan repayments.

Because of the appreciation in real estate values in recent years, many elderly homeowners of modest means find themselves living in valuable homes in the classic "house rich, but cash poor" dilemma.[1] Prior to the availability of home equity conversion, these homeowners had two basic choices: to sell their homes and move to rented quarters, or to "make do" in their present homes. Home equity conversion offers additional alternatives, but not without both costs and risks. It may not be advisable for most elderly homeowners; but for those with a strong desire to remain in their homes and without the means to do so, some form of home equity conversion may be an appropriate option that could improve their quality of life.

Several basic home equity conversion methods exist, including both sale and loan formats.[2] The principal types are reverse mortgage loans, sale-leasebacks, and sale of remainder interests. Although the three methods differ in form and in substance, they all share similar characteristics: they liquify all or a portion of the equity in the home; they entail costs to the homeowner in the form of transaction costs, interest, foregone appreciation, or otherwise; and they involve some risk for both parties to the transaction.

The major attraction of home equity conversion to elderly homeowners is that it provides a way to supplement their income. However, collateral benefits that may result include extending the homeowner's independence and control over his or her life, allowing the homeowner to live more comfortably, and reducing the homeowner's dependence on public programs.

This manual describes the three most common methods of home equity conversion and raises significant issues related to each method. The scope of this manual is not broad enough to answer all the questions an attorney may have about home equity conversion, and not all of the issues that should be considered in connection with a specific transaction may be raised. This manual is directed to attorneys representing the elderly rather than to attorneys representing lenders or investors in home equity conversion transactions.[3]

Overall Considerations in Counseling

A decision concerning home equity conversion in later life is a major financial decision—possibly the single most important financial decision a person will ever have to make. Many personal and financial factors—including financial planning, tax planning, and estate planning considerations—should be taken into account before an elderly homeowner decides to undertake home equity conversion. Proper counseling for home equity conversion thus encompasses a complete evaluation of the client's overall retirement planning including the client's eligibility for public benefit programs (especially Medicaid). The client's personal needs and health, as well as the client's life expectancy, should also be considered.

In many of these areas, an attorney may be a skilled counselor. In other areas, however, professional advice from accountants, financial planners, social workers, and gerontologists, as well as input from family members or friends of the client, may be needed. Home equity conversion transactions are complex and may have important ramifications which could prove disastrous to an elderly person if they are overlooked.

The homeowner's attorney thus has an important role to play in the decision-making process, not only because each home equity conversion method raises many legal issues but also because an in-depth analysis of the homeowner's particular situation is required. The specific legal issues vary according to the home equity conversion method being considered, but some general considerations follow.

The most basic questions relate to the client's attitudes and needs, and the best way to meet or fulfill these. Home equity conversion is definitely not suited to most elderly homeowners. For example, homeowners who would prefer to move, who do not have sufficient equity in their homes, whose first priority is preservation of their estates, or who do not need supplementary income generally should not consider home equity conversion. Homeowners with a strong resistance to incurring debt should not be advised to take out a reverse mortgage; those who do not want to relinquish ownership rights to their homes should not enter into a sale-leaseback transaction; and those who do not have other assets to fall back on should not in most cases take out a short-term reverse mortgage.

Overall economic questions include these: How attractive a plan is this for the client? What will the client relinquish and what will the client receive in return? Is this method the most appropriate vehicle to meet the needs of the client? A cost-benefit analysis over the expected life of the client should be performed in answering these questions.

The ability to devise real property to their heirs (even though the heirs may not want the property) is important to many elderly people and is an issue that needs to be seriously considered early in the counseling process. To the extent that home equity is converted to a liquid asset and "used up," it is removed from the owner's estate. The interests and expectations of family members should be understood and discussed so that the client and the client's family members thoroughly understand the implications of this decision. However, counsel should recognize the elderly homeowners as the client even though family members may have initiated contact with the attorney, may attend to the legal and nonlegal needs of the client, may assist in the decision-making, and may even pay the attorney's fees. In other cases, where the family members (or other prospective heirs) are not already involved, bringing them into the decision-making process may prevent later disappointment of their expectations, and may even result in a family decision to supplement their elderly parent's income themselves rather than using home equity conversion to accomplish this.

Basic information and guidance concerning the various home equity conversion methods are available in many areas through the Consumer Housing Information Service for Seniors (CHISS), which uses trained volunteers (who are not attorneys) to convey information. The American Association of Retired Persons (AARP) sponsors this program, which now has volunteers in several states trained to provide housing information to the elderly. These volunteers are available both to provide information to older individuals concerning home equity conversion and to help them examine other housing and income supplementation alternatives relating to their homes. For answers to more technical questions and for further counseling, these volunteers refer their clients to agencies having the appropriate expertise.

Reverse Mortgage Loans

To date, two kinds of reverse mortgage loans have been available on a limited scale: (1) a fixed-term, fixed interest rate reverse mortgage loan; and (2) a shared-appreciation reverse mortgage loan, in which the lender charges a fixed interest rate plus a share (or all) of the appreciation in value of the property over the loan term as additional interest, but with an open-ended term effectively limited only by the borrower's occupancy of the home. In both kinds of reverse-mortgage loans, the borrower receives monthly advances throughout the loan term.[4] Reverse mortgages were originally (and sometimes still are) called "reverse annuity mortgages." This may be due to their annuity-like feature of providing regular monthly advances to the borrower.

The Structure of Reverse Mortgage Loans

Periodic Advances. Structurally, a reverse mortgage loan is more comparable to a construction loan than to a "forward" mortgage loan, since it is a rising-debt loan. At closing, the borrower receives an advance sufficient to cover closing costs (unless the borrower pays these costs in cash). In some instances, the borrower also receives a modest lump sum advance earmarked for a special purpose, such as necessary roof repairs or a new furnace, or to pay back taxes. Thereafter, the borrower receives monthly advances according to a predetermined schedule. These are generally equal in amount, but it may be possible to arrange a reverse mortgage with a schedule of graduated advances.

Compound Interest. Interest on the advances received by the borrower accrues and is added to the principal, usually monthly.[5]

Loan Amount. The amount of the monthly advances is determined in part by the value of the house. When the borrower applies for a loan, the house is appraised and a projected maximum balance is established, often using the same loan-to-value ratios (approximately 70 to 80 percent) used by lenders for forward mortgage loans. The projected maximum loan balance consists of two components: (1) the aggregate principal advances to the borrower over the loan term, plus (2) accrued, compounded interest. In a fixed-term reverse mortgage loan, the lender can accurately project the maximum amount of the principal advances to the borrower. For an unlimited-term loan with unlimited advances, the maximum amount of the principal advances is projected on the lender's expectation of how long the borrower will remain in the home, a projection that cannot be completely accurate.

The maximum loan amount is determined by a number of variables in addition to the value of the house: the length of the term desired by the borrower (or projected by the lender), the amount of the monthly advance sought by the borrower, and the interest rate. In the case of the unlimited-term shared-appreciation loan, the projected appreciation to be shared with the lender is taken into consideration in determining the amount of the monthly payments.

Repayment. No repayment is due during the term of the loan. At the end of the loan term, the entire principal amount advanced, plus accrued compounded interest, is due and payable in one balloon payment. In a shared-appreciation reverse mortgage loan, additional interest in the amount of the lender's share of the appreciation in the value of the home over the loan term (as determined by appraisal) is also due and payable.

Term. As discussed above, a reverse mortgage loan may have either a fixed or an "unlimited" term. An unlimited-term reverse mortgage will be subject to various events of borrower default, as discussed below.

What to Look For in a Reverse Mortgage

The borrower's counsel should carefully review the reverse mortgage documents. These will usually consist of a note, a mortgage, a loan agreement, and Truth-in-Lending and "alternative mortgage transaction" disclosures. Because of the relative rarity of these transactions, no standard forms such as those for FNMA of FHMLC have been developed. Thus the borrower's counsel will need to review the loan package much more carefully than the traditional "forward" mortgage loan package to ensure that the documents accurately reflect the transaction as understood by the borrower.

The note should provide for the periodic advances agreed upon, the fixed interest rate, the shared-appreciation additional interest (if applicable), the term, and the maximum loan amount.[6] Specific provisions to look for are discussed below.

Prepayment. To permit the borrower to react to any change in circumstances, the loan documents should provide that the loan is prepayable in full without penalty. It is desirable that partial prepayments be permitted without penalty as well, to retain maximum flexibility for the borrower.

End-of-Term Borrower Default. The provisions of the loan documents establishing the end of the loan term and events of borrower default should be closely examined and clearly understood by both the borrower and the borrower's counsel. Early termination of the advances could force the borrower to sell the house and move prematurely in order to repay the loan. Because of the nature of reverse mortgage defaults (as discussed below), many reverse mortgages terminate upon an event of default rather than term expiration.

Fixed-term reverse mortgages simply set a date certain as the loan termination date. The only shared-appreciation "unlimited term" mortgage that we know of sets the 100th birthday of the borrower (the younger borrower in the case of a married couple) as the end of the term, and provides that the term can then be renewed by the borrower if the borrower is still living and no event of default has occurred prior to that date. The numerous events of default and acceleration included in reverse mortgages, including death or cessation of occupancy, could be defined as alternative loan termination dates instead of events of default, but no loan documents that we have seen do so.

Reverse mortgage loan documents generally include two major categories of events of borrower default which will trigger the lender's right to accelerate the loan balance: (1) transfer by the borrower of all or any part of any legal or beneficial interest in the property, and (2) cessation of the borrower's occupancy of the property. These may be thought of as an extensive "due-on-sale" clause and a "due-on-cessation-of-occupancy" clause.[7] Many of the events of default, discussed in more detail below, are not found in other residential mortgages.

Reverse mortgage lenders can be expected to provide for acceleration of the loan upon the death of the borrower or the earlier sale of the property. In both a fixed-term reverse mortgage loan and an "unlimited term" shared-appreciation reverse mortgage loan, the loan generally will end and the balance become due and payable upon the occurrence of any of the following events of default: (1) if the borrower (or the survivor in the case of joint borrowers) dies; (2) if the borrower rents or leases the home (or in some situations, part of the home); (3) if the borrower changes his or her principal place of residence either voluntarily or involuntarily (such as entering a nursing home with no medical prospect of

leaving); and (4) if the borrower abandons, sells, or gives away the home. Generally, further encumbrances are also an event of default because of the risk that such encumbrances will obtain priority over future advances (and/or accruing interest) under the reverse mortgage loan, despite the obligatory nature of these advances.

In addition, the same kinds of events that are defaults under forward mortgage loans are typically included as events of default in a reverse mortgage: failure to insure the home, failure to maintain and repair the home, permitting waste to occur, condemnation, failure to pay taxes and failure to pay the loan when due. However, counsel for the borrower should ensure that the loan documents do not prematurely cut off the borrower's right to occupy the home. For example, if a borrower is forced for medical reasons to reside elsewhere temporarily, but has a reasonable prospect of returning to the home, this should not be construed as cessation of occupancy.

Counsel for the borrower should further ensure that the loan fits the borrower's tenure expectations and that it fits into the borrower's overall retirement plan; the borrower should not be left without resources upon termination of the loan. In a fixed-term reverse mortgage loan, the homeowner will have to sell the home upon the expiration of the fixed term regardless of what the borrower's circumstances may then be, unless the borrower has other resources to repay or refinance the loan. The home may appreciate sufficiently over the term of the loan to permit a refinanced reverse mortgage, with the balloon payment due on the old loan paid out as a lump-sum initial advance. The interest on such a large initial advance, however, would quickly deplete any remaining and/or appreciated equity in the home. Thus, this "solution" is of limited use.

Although payment default logically can occur only in connection with failure to pay the entire loan balance when due, the borrower's counsel should closely examine the provisions concerning the timing of repayment to ensure that the borrower or the borrower's estate has a reasonable time to arrange for payment of the loan (normally by sale of the home) upon an event (especially an involuntary event) that gives rise to acceleration. The borrower's counsel should examine in this connection any late charge or default interest rate and/or loss of the protection of any limitation of liability if the balance due is not paid within the specified time frame.

Nonrecourse Provision/Limitation of Liability. "Nonrecourse" or limitation-of-liability provisions in favor of the borrower in reverse mortgage loan documents obviously are desirable from the borrower's point of view. The effect of these provisions is to limit the lender's recovery under the loan to the proceeds of foreclosure. Some states, of course, limit a mortgage lender's recovery in general pursuant to anti-deficiency or one-action legislation. Thus the presence or absence of provisions limiting the borrower's liability will need to be read against the backdrop of state law.

The absence of nonrecourse or limitation-of-liability provisions results in the borrower or the borrower's estate being liable for the entire loan balance. Because of the rising-debt nature of a reverse mortgage loan, this is a grave exposure and probably should not be undertaken. If, as a result of accrued interest, a decline in property values, or accrual of penalty charges, the loan balance exceeds the value of the house, the borrower or the borrower's estate could face substantial liability.

Lender Default; Assignment by Lender. The borrower's counsel should also closely review the provisions of the loan documents regarding lender default and transferability of the loan by the lender. In a forward mortgage loan (other than a construction or line-of-credit loan), virtually the only opportunity for lender default is at loan closing, i.e., failure of the lender to advance the loan balance. In a reverse mortgage loan, failure to advance payments could occur at any time. Although a borrower would have a contractual cause of action against the lender for failure to make promised advances, the value of this remedy to the borrower is questionable, both substantively and procedurally. Arguably, the borrower could incur substantial consequential damages that might not be recoverable and could be put to the task of suing monthly for each advance as it came due. Almost certainly, the borrower could not afford to pursue such remedies. Meanwhile, interest on funds previously advanced would continue to accrue and compound.

To the extent that lender default provisions are included in the loan documents, borrower's counsel should further consider to what extent they include exclusive liquidated damages provisions in favor of the lender or other limitations of the lender's liability. Although an elective liquidated damages provision is desirable from the borrower's viewpoint, an exclusive liquidated damages provision limiting the availability of alternative remedies is not. A clause providing for payment of attorneys' fees to the prevailing party by the nonprevailing party in the event of default may be desirable. The borrower's counsel must consider, however, that the lender's failure to make advances may simply mean that the lender has no assets from which recovery may be had. Thus a desirable remedy for lender default would be a forgiveness or limitation of the borrower's liability for the principal and/or interest advanced or accrued.

Because of the impact of lender default on the borrower, the borrower and the borrower's counsel should have a greater than usual interest in the financial strength of the lender and the continued liability of the original lender in the event that the loan is sold. Although there is no developed secondary market for reverse mortgage loans, the lender could theoretically transfer the loan to another lender or even to a "shell." Thus the loan documents should provide for continued liability of the original lender in the event of transfer and for transfer only to a financially sound transferee who expressly assumes the lender's obligation.

Joint Borrowers. In the case of joint borrowers, counsel should review the documents to ensure that acceleration is triggered only by the death or termination of occupancy of both (or the latter of the two) borrowers.

Casualty and Condemnation Provisions. The borrower's counsel should review the mortgage provisions regarding insurance and condemnation proceeds. These provisions should require the lender to permit repair and reconstruction of the home in the event of a major casualty (except in the event of substantially total taking by eminent domain). The borrower should be advised of the importance of carrying adequate insurance coverage to protect the full extent of the borrower's equity so that the home can be rebuilt in the event of a major casualty.

Disclosures. The lender must provide the borrower with the standard Truth-in-Lending disclosure statement. The lender must provide an alternative mortgage disclosure statement as well, pursuant to federal law or otherwise.[8] These should be helpful in determining the real cost of the loan to the borrower. In order to properly evaluate the Truth-in-Lending statement, counsel will have to determine what assumptions, if any, have been used to calculate estimated loan amounts in the disclosure.

Considerations for the Borrower

As with all forms of home equity conversion, the suitability of a reverse mortgage for a given individual should be carefully examined.

Tenure Expectations. A prime consideration is tenure expectancy. Clearly, a fixed-term reverse mortgage is not practical for a borrower who wishes to remain in the home beyond the stated term and who does not have assets to resort to upon termination of the loan. Ideally, the term of a fixed-term reverse mortgage will be linked to an event such as the elderly homeowner's entry into a congregate housing facility, life care community or retirement home, or a move in with family members. Sometimes, short-term reverse mortgages have been used to purchase home care for persons with terminal illnesses.

Lien-free House. A reverse mortgage generally requires a lien-free house, or one with ony a small mortgage balance that can be repaid at loan closing.[9]

Burdens and Benefits of Ownership. A homeowner who chooses a reverse mortgage will be left with most of the burdens and benefits of home ownership. The borrower remains responsible for property taxes, insurance, and maintenance and repair of the property. The borrower retains possession and remains the beneficiary of any appreciation in value of the home over the term of the loan, unless the lender is contractually entitled to some or all of the appreciation. In existing loan programs, the transfer to the lender of part or all of the appreciation of the house has been the price for obtaining an "unlimited" loan term. Anticipated appreciation is thus a factor to be seriously considered from both sides of the transaction. Moreover, even without shared appreciation, failure to repay the loan in a timely manner could eat into and even devour any retained equity or appreciation due to the accrual of additional interest and/or imposition of penalties.

Cost. The overall cost to the borrower should be carefully considered, based on the expected term of the loan. The cost of accrued, compounded interest and any appreciation sharing should be considered first.[10] Lenders may also charge points in the form of loan fees based on the ultimate anticipated loan balance. Other closing costs typically attendant to a mortgage loan will also be incurred. Thus, as with a forward mortgage loan, a short-term reverse mortgage loan becomes an expensive prospect.

Income Tax Effects. Finally, a reverse mortgage borrower should realize that the interest on the loan will not be deductible for tax purposes until it is paid, generating an unduly large deduction in one year only.

Lending Authority. Borrower's counsel may also wish to examine the lender's authority to make the loan. The source of this authority may vary slightly from state to state. Counsel should review applicable state authority locally. For federal authority, see the Garn-St. Germain Depository Institutions Act of 1982, 12 U.S.C.A., Section 3801 *et seq.* and the regulations issued thereunder. If a loan were determined to be an *ultra vires* or illegal act by the lender, the borrower could be left in the same position as in the event of a lender default, as discussed above.

Sale-Leasebacks

In a sale-leaseback type of home equity conversion, an elderly homeowner sells his or her home to a buyer, who then leases the home back to the seller. Although the basic structure of such a transaction is easy to grasp, the transaction actually involves most of the same complex economic and tax questions that arise in a sale-leaseback of commercial real estate.

While most sale-leasebacks are privately arranged, several commercial programs or organizations involved in sale-leaseback home equity conversions use seller financing of the purchase in the transactions. There are two likely reasons for this. First, this kind of sale-leaseback was developed during a period of peak interest rates, when institutional financing was too expensive for most buyers and when interest rates on seller financing offered sellers a good alternative to investment of the proceeds of a cash sale. Second, it is critical to the seller that the seller's rights as tenant under the lease be prior to the lien of any mortgage on the property in order to prevent termination of the lease in the event of a foreclosure; few institutional lenders would find this subordinate lien status acceptable.

Sale-leasebacks are theoretically quite attractive, but they offer several practical problems. The most serious is the difficulty of attracting interested buyers. In most instances, these transactions result in a negative cash flow to the buyer. Tax deductions and property appreciation over the term of the investment are necessary to generate a positive return. Thus, as with commercial sale-leasebacks, careful structuring is necessary to assure the buyer the benefit of tax deductions. (Tax considerations are discussed in more detail below.)

Moreover, because of its complexity, the transaction costs to both sides can be high. The organizations and programs offering home equity conversion have reduced these costs to some extent by standardizing the transactions.

In negotiating the transaction from either side, both the terms of the sale and of the lease need to be carefully considered; the dual nature of the transaction will affect the terms of each. Issues unique to a home equity conversion transaction are discussed below in the context of sale-leaseback home equity conversion documents.[11]

Sale-Leaseback Agreement

The sale-leaseback agreement should set out the terms and conditions of the sale and the lease. The agreement should have attached as exhibits full copies of the lease, a memorandum or notice of lease, and any seller financing documents, each of which should be reviewed and negotiated as necessary. Counsel to both seller and buyer should consider all of the usual issues that are raised by a residential sale transaction, in addition to the issues discussed below.

Purchase Price. The purchase price of the property is subject to the usual negotiation. Although there is a natural tendency to let the terms of the leaseback affect the purchase price, a price less than the actual fair market value of the property could have undesirable tax effects. Tax issues are discussed in more detail below.

Method of Payment. As noted previously, it may be necessary or desirable to have the seller finance a portion of the purchase price by means of a note secured by a mortgage or deed of trust on the property. The buyer may not be able to obtain an institutional mortgage subordinate to the seller's lease (a critical protection of the seller), or the seller may get a better return on the note than the seller would get on an alternative investment of the sale proceeds. The buyer's note, however, will be an illiquid investment and subject to a risk of default.

If the seller finances a portion of the price, the buyer should in all events be required to make a down payment large enough to give the buyer a substantial equity interest in the property as an incentive to prevent default. In addition, the tax and cash flow consequences of any proposed transaction should be analyzed to determine whether a given seller would benefit from a larger or smaller cash down payment. How the size of the down payment affects the buyer's willingness to proceed with the transaction should not be ignored.

The interest rate of the note that the seller takes back from the buyer will, of course, be the primary determinant of how advantageous seller financing is for the seller. The interest rate will also be affected by the imputed interest rate limitations of the Internal Revenue Code.[12]

Investment of Cash Proceeds. The seller will have to decide how best to invest or spend any cash received (a down payment, a balloon payment, or the full sale price.) This concern is really no different than if the seller sold the home and moved to an apartment. Especially if the home is the seller's only valuable asset (as is usually the case), the seller should arrange for an assured flow of income for the seller's life. The seller must set up an investment plan so as not to be without a source of support after spending the sale proceeds.

One investment that the seller should consider is an annuity. At least one sale-leaseback home equity conversion program *requires* the purchase of an annuity as part of the transaction. There are different kinds of annuities, and prices may vary significantly from issuer to issuer and from time to time. If the seller elects to buy an annuity, it is important to select a financially stable issuer. The seller should consider both relative cost and investment return in evaluating investment in an annuity. The income generated by an annuity should be compared with alternative investments. Notwithstanding the relative security of an annuity, the return on investment may make it an unattractive investment.

The likely effect of inflation should, of course, be considered in any investment plan.

Repairs Prior to Sale. The buyer will have an interest in needed repairs to the property, but the seller should also carefully consider what repairs need to be made to the property at closing or will need to be made in the foreseeable future. Because the seller intends to continue living in the property for a period of years, it is in the seller's interest as well as the buyer's to ensure that any substantial repairs to the property that are needed are made either prior to closing or out of escrowed sale proceeds, notwithstanding that this will reduce the net proceeds to the seller.

Identity of the Buyer. If the seller is financing the sale, the sale-leaseback agreement should provide that the buyer's rights under the agreement may not be assigned, so that the original buyer is the obligor under the seller financing. If the seller is financing the sale, seller's counsel should obtain a thorough credit check on the buyer to be sure that the buyer will be able to service the note and be able to maintain the property.

The seller should understand that after the home is sold the buyer will be entitled to sell the home without the seller's consent to whomever the buyer chooses. Restraining the buyer's ability to resell the property (other than indirectly, through a due-on-sale clause in any seller financing documents, permitting the seller to declare the entire outstanding balance of the note due if the buyer sells or transfers the home) is neither practical nor advisable; it would likely be unenforceable, might dissuade otherwise interested buyers, and could have adverse tax consequences (discussed further below).[13] The seller's interest as tenant should, however, be protected in the event of sale by the memorandum or notice of lease, as discussed below.

There is probably no way to protect the seller's lease from the landlord's bankruptcy.[14] However, at least as to the initial buyer, a credit check will serve to reduce this risk.

Promissory Note. If the seller finances the sale, the terms of the note will need to be negotiated, including the interest rate (and whether it will be fixed or variable) and the installment payments.[15] A sale-leaseback calling for a balloon payment to the seller after a period of years would require that the timing of the balloon payment be negotiated as well. The seller may want the term of the note to equal his or her actual life expectancy. Estate planning may be a concern here; a note's lack of liquidity may make it an undesirable estate asset. Seller's counsel should discuss with the seller the advantages and disadvantages of a sizable prepayment penalty and/or a prohibition against prepayment since it may affect the seller's investment planning.

Mortgage or Deed of Trust

If the seller finances the sale, the note should be secured by a mortgage or deed of trust on the property. As discussed above, the lease to the seller should be prior to the mortgage or deed of trust in order to prevent the seller's rights from being shut off in the event a third party should purchase the property at a foreclosure sale. For the same reason, the seller's deed of trust or mortgage should be a first mortgage or deed of trust, and any prior outstanding encumbrances should be paid off. As discussed previously in connection with the note, seller's counsel should advise that a due-on-sale clause be included in the mortgage or deed of trust.

Lease

The term of lease (between the buyer of the property as landlord and the seller of the property as tenant) should commence upon the closing of the sale.

Term. From the seller/tenant's point of view, a lifetime lease would be most desirable. However, there is some risk that a lifetime lease would be treated as a life estate for tax purposes, with adverse tax effects for both parties. (See "Tax Consequences" below.) Further, the buyer/landlord will want to gain possession of the property free of the lease as soon as possible. This would suggest a fixed-term lease or at least one that terminates upon the seller's moving out of the home, for whatever reason. Counsel for the tenant needs to pay close attention that whatever term is negotiated fits the tenant's plans and tenure expectations. A compromise might be a one-year term that is automatically renewed for successive one-year periods so long as the original tenant remains in the home or until the tenant gives the landlord notice of termination at the end of any one-year period. When change of occupancy or the death of the tenant (or of the survivor, in the case of a married couple) occurs, the lease term would expire at the end of the one-year renewal during which the change of occupancy or death occurs.

Rent. The rent payable under the lease should be negotiated at the time of the sale. Both the landlord and the tenant may be well served by obtaining a professional appraisal of the fair rental value of the property. A rent that is less than a market rent may mischaracterize the transaction for tax purposes. (See "Tax Consequences.")

Rent increases must also be carefully considered. Tenant's counsel should require a cap on increases so that the rent cannot be raised beyond the tenant's means, forcing the tenant to vacate. A Consumer Price Index escalator with a cap, similar to those used in commercial leases, may be desirable, but the tax effects of the escalator and cap, if they bring the rent below market, also need to be considered.

Local rent control and eviction limitation ordinances should be considered. If local rent control and/or eviction limitations are stricter than the lease provisions, the lease will likely be limited as provided by the local ordinance, and counsel to both parties will have to take this into account in structuring the transaction.

Subletting. If both parties agree that the lease term should be based on the tenant's occupancy, the right to sublet or assign becomes important. Both the landlord and the tenant should consider the tenant's right to assign the lease or sublet or permit others to live in the home with the tenant. It is reasonable to permit others to live in the home, so long as the original tenant lives there also, and so long as the home does not become overcrowded. Absences from the home by the original tenant should be permitted, whether for medical or personal reasons. Landlord's counsel should consider recent cases that limit a landlord's right to withhold consent to assignment or subletting.[16]

Repairs, Taxes, and Insurance. The lease typically should provide that the landlord will be responsible for major repairs, as well as for property taxes and assessments on the home. It might also include a provision that neither the landlord nor the tenant may make capital improvements to the property without the consent of the other. The responsibility for major repairs needed at the time of closing or that may be needed soon thereafter should be negotiated and the repairs made or arranged for prior to closing.

The lease should require both the landlord and the tenant to carry public liability and property damage insurance with specified coverage amounts. The landlord should be required to carry fire and casualty insurance equal to 100 percent of the property's replacement value, and the tenant should be required to carry fire and extended coverage insurance on his or her personal property. Adjustment of coverage limits over time should also be provided for. The insurance provisions of the lease should resemble commercial lease insurance provisions with mutual waivers of subrogation, prior notice of cancellation, and certificates of insurance provided for. It is especially important for tenant's counsel to ensure that the landlord maintains the required coverage. If the tenant holds a note from the landlord, the tenant should also have mortgagee's coverage.

Damage or Destruction; Condemnation. The lease should also provide that if the home is damaged or destroyed by a casualty that is required to be covered by the landlord's casualty insurance, the lease will not be terminated and the landlord will be required to repair and rebuild the house. Tenant's counsel may also wish to require the landlord to carry insurance to cover commonly uninsured casualties, such as earthquakes or floods. However, the landlord will generally seek to pass on such insurance premiums to the tenant by charging a higher rent. The landlord should also be required to repair and rebuild in the event of an uninsured casualty if the damage is minor.

Counsel for both parties should also consider the likely effect of a condemnation. Many states have a statutory allocation of damages or compensation between landlord and tenant that may or may not be satisfactory to the parties. If it is not satisfactory, or if no statutory allocation applies, the lease provisions should alter or provide for the division of proceeds.

Application of insurance proceeds and condemnation awards is one of the areas in which it is particularly important for the lease to be prior to any third-party mortgage.

Default. Because of the importance of the lease to the tenant, the default provisions of the lease should vary from a typical residential lease in two ways. First, tenant's counsel should consider adding provisions protecting the tenant's estate under the lease against termination even beyond the extensive tenant protections provided by statute in many states. Second, provisions governing the landlord's defaults and the tenant's remedies should be added. In states where a tenant does not have a statutory repair-and-deduct remedy, this remedy should be expressly included. In states that do have such a statutory remedy, tenant's counsel should consider expanding the right. If the landlord is making payments to the tenant pursuant to a note, counsel for both parties should consider adding a setoff provision to the lease in the event of a default under the note, and vice versa. The setoff provision, which would allow the nondefaulting party to discontinue payments without penalty, would be triggered by the buyer's failure to pay on the note or by the tenant's failure to pay rent. This will affect the negotiability of the note.

Memorandum or Notice of Lease

The tenant and the landlord should sign a memorandum or notice of lease and record it in the appropriate land records at the same time that the deed is recorded. The memorandum or notice of lease should be recorded after the deed but before any mortgage or deed of trust (either to the seller or to any third-party lender) is recorded. The memorandum or notice of lease should be expressly superior to any mortgage or deed of trust, and any mortgage or deed of trust should be expressly subordinate to the memorandum or notice of lease. Otherwise, the seller's lease could be terminated in the event of a foreclosure.

Upon lease termination, the buyer will want to clear the memorandum or notice of lease from the buyer's title to the property. This can be done by obtaining a quit claim deed from the tenant if the tenant is available to sign it. The memorandum or notice of lease could also provide that a recorded death certificate of the tenant will serve to terminate the memorandum or notice. If the tenant is in failing health or subsequently encounters failing health, a durable power of attorney might be advisable. This instrument, properly drafted, would enable the attorney-in-fact to convey the grantor's interest when the tenant is unable to do so. Obviously, other considerations (e.g., who is an appropriate attorney-in-fact and what other provisions might be necessary or desirable) should be well thought out prior to the drafting of a durable power of attorney.

In most states, the buyer will obtain title insurance on the property. Counsel to the seller/tenant should also obtain a leasehold policy and, if the seller has financed the sale, a lender's policy for the seller/tenant. This coverage should be available for a small additional premium when issued in conjunction with the buyer's policy.

Tax Consequences

The tax treatment of sale-leasebacks is complex, and the tax treatment of the transaction is usually important, if not fundamental, to the parties to the transaction. If buyer's and seller's counsel are not skilled tax practitioners, each should consult a tax specialist to ensure that the client's expectations with respect to tax consequences are likely to be met.[17]

Two major risks that a sale-leaseback faces are (1) that it will be treated as a disguised financing device (where the seller continues to be treated as the owner of the property for tax purposes) and (2) that it will be treated as the sale of only a partial interest in the property, with the seller retaining an ownership interest. In the latter case:

> If the transaction is treated as a sale of a remainder interest, the seller/tenant, who is treated as the owner for the retained interest, will be entitled to all tax benefits with respect to such retained interest and taxable on all income resulting therefrom. On the other hand, if the transaction is treated as a sale-leaseback, the purchaser/landlord will be considered to have acquired the entire property, including the retained interest, for a purchase price equal to the stated purchase price in the contract plus the fair market value of the retained interest. The seller/tenant, on the other hand, will be treated as having realized on the sale the stated purchase price plus the fair market value of the retained interest. Finally, the fair market value of the retained interest will be treated as prepaid rent from the seller/tenant to the purchaser/landlord. If the seller/tenant's retained right to income is treated as additional proceeds from the sale, the income on the property is treated as taxable to the purchaser/landlord and then paid over to the seller as the additional proceeds. In each of the latter two situations, the purchaser/landlord will be entitled to all tax benefits with respect to the entire property from "Sale-Leaseback Transactions." See footnote 14 for complete citation.)

The problems most likely to arise in a sale-leaseback home equity conversion would result from a purchase price less than the full fair market value of the house, from a rent less than the full fair market rent, or from a lease measured strictly by the seller's life. These factors could all result in the seller being deemed to have retained an interest in the property. In the first two cases, the difference between the actual price or rent and the full fair market price or rent could constitute gain to the seller and prepaid rent to the buyer. In the third case, the buyer would lose current tax deductions. If the seller is deemed to have retained an interest in the property this will affect the amount of the deductions allowed to the purchaser and could affect whether some deductions are available at all.

The availability of the one-time capital gain exclusion to the seller should also be taken into account in structuring the transaction.[18]

The effects of bankruptcy of the buyer or any successor owner of the property should also be discussed with the seller.[19]

Sale of Remainder Interests

This method of home equity conversion traditionally involves the homeowner selling a remainder interest in the property and retaining a life estate. With ownership of the life estate come the obligations inherent in life tenancy, including maintenance, repairs, and payment of property taxes and insurance premiums. The value of the life estate is determined by the age of the homeowner and the appraised value of the home. An Internal Revenue Code regulation contains tables which can be used to determine life estate and remainder interest values.[20]

The homeowner is free to spend or invest the lump-sum payment received as consideration for the remainder interest. However, institutional financing is rarely available for the purchase of a remainder interest. Thus, unless the buyer has cash, the elderly seller will probably have to accept installment payments evidenced by a note secured by a deed of trust or a mortgage on the remainder interest. Such installment payments may be used to supplement other forms of income to the life tenant and in some cases may reduce the capital gains taxes that would result from lump sum payment.

Elderly homeowners interested in selling a remainder interest may not find an interested buyer since this transaction, unlike a sale-leaseback, offers the investor no current cash flow and, at this writing, no chance of tax shelter.

Sale of the remainder interest discussed here should not be confused with programs offered by some nonprofit organizations (particularly universities) in which the remainder interest in the home is *donated* to the charity. While similar in some respects, those programs are geared to provide a gift to the charity and tax benefits to the donor, and are not intended to generate income for the donor. Thus one of the central purposes in home equity conversion, the generation of income, is unavailable.

Two existing home equity conversion programs overcome the lack of potential buyers by having the elderly homeowner sell the remainder interest to the sponsoring group (a public agency or nonprofit organization) in return for a one-time lump-sum payment or monthly payments for life.[21] The agency takes over payments for routine maintenance, repairs necessary to keep the property in a safe and marketable condition, property taxes, and casualty insurance. The monthly payment to the homeowner is based on the value of the remainder interest (determined by the seller's life expectancy and the appraised value of the real property) minus the estimated costs of the additional benefits. These programs are particularly attractive in that the seller retains life estate ownership without incurring the usual burdens of that ownership.

Both of these programs also use a contract outlining the responsibilities and obligations of the parties, a deed reflecting transfer of the remainder, a manual explaining the program, and various forms used at different stages of the application process. In these programs the contract is the central document because it contains the terms of the transaction. Provisions state which party will be responsible for minor and major repairs, interior and exterior maintenance, utility bills, cosmetic changes, and lawn care; conditions under which the life estate will be prematurely terminated; rights of cancellation; and both events of default and remedies for default by either party.

A contract of this type is not used in a traditional remainder sale. It can be included as part of such a transaction, however, if both parties wish to relinquish or accept obligations which are different from those normally imposed by applicable law.

Issues concerning sale of a remainder interest that merit additional comment are (1) ownership, (2) occupancy, (3) default, (4) tax implications, and (5) early death.

Ownership

As noted earlier, "ownership" of their home often is a primary concern of elderly homeowners. For those elderly homeowners to whom ownership is important, sale of a remainder may be appealing. The homeowner retains possessory ownership, while relinquishing the right and ability to devise the homestead to heirs or to benefit from appreciation in value of the property.

Occupancy

One of the main purposes of home equity conversion is to provide a way for elderly homeowners to continue living in their own homes. Therefore, providing assurance that the homeowners will have continued occupancy of the premises is of utmost concern in such a transaction. A life estate provides reasonable certainty as to occupancy rights. The buyer (or remainderman) may request, however, that the elderly life tenant agree to relinquish the life estate under certain circumstances, for example, if the life tenant is institutionalized. Placement in a nursing home is not always permanent, but projecting the length of stay may be difficult. The remainderman has a legitimate interest in preserving the realty from waste; indeed, the life tenant is liable in damages for waste and in some states the life estate may be statutorily forfeited. Therefore, an indefinite absence or vacancy may not be tolerated.

In one of the existing programs facilitating sales of remainders, the remainderman is contractually permitted after a three-month absence by the homeowner to rent the premises to a third party on a month-to-month basis. Rents and profits derived from the rental are first applied to the cost of removing and storing the life tenant's personal property, and the difference is retained by the program rather than by the life tenant. This contradicts the traditional view that rents derived during the life estate belong to the life tenant, but a homeowner may be willing to sacrifice this right in order to participate in the program. Moreover, the life tenant will continue throughout the absence to receive the monthly stipend. When the life tenant is willing and is able to move back in, this can be accomplished simply by giving notice to the temporary tenant.

The same program considers the home to be abandoned if the life tenant is absent for a six-month period. Such abandonment is considered a breach of the agreement and requires the life tenant to relinquish the life tenancy. Again, the life tenant continues to receive the monthly payments for life, but the sponsoring agency may sell the home and free itself from its contractual obligations to maintain the property.

The promise of lifetime monthly payments in these programs is a significant deviation from the traditional sale of a remainder in which the seller's life expectancy and the appraised value of the real property determine the purchase price of the remainder. The payout could be structured in installments over the life expectancy of the life tenant. However, the installment payments would not extend beyond a date certain, regardless of the life tenant's possible longevity.

Contractual provisions dealing with vacancy, abandonment, default, notice, and the parties' obligations must be carefully drafted so as to properly preserve the life tenant's interest and accompanying rights in the property. The life tenant's attorney obviously plays a key role in a transaction of this nature.

Default by Remainderman

Where the remainderman has ongoing obligations to the holder of the life estate pursuant to a promissory note or an ongoing agreement, default by the remainderman will be an issue of concern. Remedies available to the life estate holder for material defaults include accelerating the note and foreclosing the mortgage or deed of trust; they could also include rescission of the entire agreement, requiring the return conveyance of the remainder interest previously conveyed.

If an ongoing agreement is executed as part of the transaction, the agreement should incorporate specific remedies appropriate to specific defaults and should include reasonable opportunity to cure any event leading to default. Events which might be considered as triggering default under a note include transfer of the remainder interest by the buyer/borrower, death of the borrower, insolvency, and non-payment. Statutory restrictions and equitable restrictions on enforcement of remedies in the event of default should be taken into account.[22] If the remainderman has no ongoing obligations to the life tenant, transfer of the remainder interest and death or insolvency of the remainderman will not affect the life tenant and cannot be deemed defaults.

Tax Implications

Tax benefits to the remainderman have not been an issue for the two programs offering sales of remainders since the programs are offered by governmental or nonprofit agencies. Significant tax issues do arise, however, for private investors interested in purchasing a remainder interest. Sellers too may face unwelcome tax consequences.

According to at least one private letter ruling,[23] the holder of a rent-free life estate cannot qualify for the one-time capital gains exclusion available to those who sell a fee simple interest[24] because the full fee is not transferred in a sale of a remainder. Under the Internal Revenue Code, the remainderman cannot deduct expenses incurred in repairing or maintaining the property, nor can the remainderman depreciate the property.[25]

In both programs discussed above, the estate retained by the elderly seller appears to be less than a life estate because of the contractual provision forfeiting the life estate upon six month's absence, as well as the provisions delegating many of the risks and responsibilities of present ownership to the remainderman. However, since the Internal Revenue Service is interpreting the Internal Revenue Code Section 121's "sale of principal residence" as requiring disposal of the fee simple absolute, even the retention of less than a life estate may disqualify the seller for the one-time capital gains exclusion. Therefore, homeowners selling a remainder interest should be prepared to pay taxes on the gain derived from the transaction, taking basis into consideration, whether that gain be in the form of a lump-sum payment or monthly installments.

In a traditional sale of a remainder, if the seller finances a portion of the purchase price, the seller's tax situation may dictate the preferred method of payment and the size of the down payment. From a private investor's perspective, it is a distinct disadvantage that the remainderman can neither deduct expenses nor depreciate the remainder estate. Nevertheless, tax benefits could still accrue to the elderly homeowner's family if the homeowner were to execute a good faith sale for actual value to the intended heirs since estate taxes could be eliminated or diminished (depending on the size of the estate and the value of the property sold.)

Early Death of the Life Tenant

The possibility that an elderly person may die sooner rather than later is a contingency that sellers of remainder interests (and their families) should consider, whether the transaction is executed as a traditional remainder sale or as part of a nonprofit program such as those discussed above. Although both the programs discussed above offer the elderly life tenant the opportunity to cancel for any reason within one year following the date of the conveyance, such a right inheres in the life tenant alone and not in any executor or representative. If the potential heirs are particularly concerned about dissipation of the property in the event of the homeowner's early death, the seller's counsel could negotiate a sliding-scale purchase price to partially compensate the estate in the event of the life tenant's early death (within the first two or three years from date of sale, for example.)

Because an early demise would significantly alter the attractiveness of a transaction involving a life tenancy, the seller's health should be considered when weighing a proposed deal in the balance. Nevertheless, a person in poor health quite obviously may outlive someone in good health.

Effect on Public Benefits

Elderly homeowners who are interested in home equity conversion typically are seeking additional income to meet their basic needs of food, clothing, shelter, and medical care. Some of these homeowners may already receive public benefits, while others who are eligible may either have not chosen to apply or may not be aware that they meet the eligibility requirements. Many others will never need or qualify for public benefits. However, because eligibility for public benefits may be affected by proceeds of home equity conversion, attorneys counseling clients about the benefits and risks of such a transaction should not overlook this possible "cost."

"Public benefits" is a general term encompassing several government programs with "means-tested benefits." This means eligibility is based on need as determined by the recipient's "means" (i.e., income and assets). Public benefits including Supplemental Security Income (SSI), a federal program for aged, blind, or disabled persons; Medicaid; Aid to Families with Dependent Children (AFDC); and Food Stamps, are primarily federally funded and in some states, state-administered. In most states a state-funded general assistance or general relief program exists for some needy persons who do not qualify for SSI or AFDC.

Social Security, Medicare, and other government benefits which are not based on means are not affected by home equity conversion. Social Security (including survivor's and disability benefits) is not a means-tested program because its recipients qualify on the basis of quarters of credit earned in covered employment. Likewise, Medicare is a federal health insurance program available to anyone age 65 or older or to individuals under age 65 who receive Social Security disability benefits.

This section will primarily focus on how the various forms of home equity conversion would affect an SSI recipient. SSI not only provides a significant monthly cash income to many elderly recipients, but many states base eligibility for Medicaid benefits on eligibility for SSI as well. Medicaid benefits often are more important than SSI benefits since many elderly individuals face large medical expenses. However, the effect of home equity conversion on Medicaid eligibility is beyond the scope of this manual since each state has its own eligibility requirements (within the constraints of the federal Medicaid statute).[27]

SSI is a program for needy aged (65 years old or older), blind or disabled persons. Need is determined based on an applicant's "countable" income and resources. A recipient's countable income must be below a certain level that varies by state (and, in some cases, within states for various categories of eligibility) while countable resources must be within specified limits (in 1986, less than $1,700 for an individual and $2,500 for a couple; in 1987 the figures are $1,800 and $2,700 respectively).[28] Exceeding either the resources or income limitations makes a person ineligible for benefits. However, some income and resources are not "countable" because they are specifically excluded.

Regulations for state-administered programs such as Medicaid, AFDC, and food stamps and for state-funded welfare programs all have different eligibility requirements. (Food stamp programs, for example, consider household, not individual, income for eligibility.) Thus, the specific language in the regulations governing the pertinent programs in the client's state should be reviewed. If there is any ambiguity, attorneys should seek an opinion from an authority at the county or state government level to determine what, if any, position has been or might be taken on eligibility issues related to home equity conversion. Additional helpful resources include legal services offices

and Title III-funded senior citizens law programs, which practice predominantly in the public benefit area.[30]

Reverse Mortgages

Recall that a reverse mortgage is a loan advanced to the borrower in monthly installments, with principal and interest not due and payable until the end of a stated term or until the borrower stops using the home as a principal residence. Such advances from a lending institution under a promissory note collateralized by a lien on the home do not directly affect SSI eligibility. The pertinent regulation states, "Money you borrow or money you receive as repayment of a loan is not income."[31] In its Program Circular No. 09-84-OSSI dated August 1, 1984,[32] SSA again states that proceeds of a loan that the mortgagor is legally obligated to repay are not "income." The proceeds of a loan, however, would be counted as an asset if they are accumulated and not spent within the month they are received. Benefits may also be affected if the proceeds exceed the resource maximums established by SSA. A program circular is only a guideline to be followed by SSA employees. Counsel should request a determination on any cases about which they are uncertain.

Sale-Leasebacks

A home is an excluded resource, meaning its value is not counted in determining an individual's (or couple's) eligibility for SSI.[33] A "resource" currently is defined as:

> cash or other liquid assets or any real or personal property that an individual (or spouse if any) owns and could convert to cash to be used for his support and maintenance. If the individual has the power to liquidate the property, or his share of the property, it is considered a resource. If a property right cannot be liquidated, the property will not be considered a resource of the individual (or spouse).[34]

Selling a home entails converting a resource into cash. The consideration received from the sale of a home is not considered by SSA to be income; instead, it remains a resource that has changed its form.[35] In traditional sale transactions (where full title passes to the buyer and the home is converted to cash), the seller has three months from the date of the sale to purchase a new home.[36] After that, any proceeds of the sale will be considered a resource and, to the extent they exceed the individual's (or couple's) resource limit, must be spent by the end of the month of their receipt in order to retain eligibility for SSI benefits.

Similarly, in a sale-leaseback where the homeowner finances a portion of the transaction, SSA considers that portion of the buyer's monthly payments which is principal as a conversion of a resource. The interest portion of the note payments, however, is considered countable as "unearned income."[37] Thus interest received on a promissory note is charged against the recipient's monthly income limitation.[38]

Since a promissory note is considered a liquid resource,[39] SSA could require the holder of such a note to convert it to cash. However, a nontransferrable note would probably qualify as a "nonliquid resource"[40] and would be evaluated according to its equity value. If a property right cannot be liquidated, the property (personal or real) will not be considered a resource.[41] To the extent that they are relevant, these issues should be considered when drafting the note.

SSA also considers "in-kind" support and maintenance as unearned income.[42] If the seller is paying rent, the buyer's payment of real estate taxes, casualty insurance, and maintenance and repair costs should not be imputed to the seller as "in-kind" support and maintenance. These items are legal obligations of the landlord for which the tenant pays monthly consideration.

If the purchase of an annuity is part of a sale-leaseback transaction, SSA considers the payments received from the annuity to be unearned income.[43] Unearned income is used to determine eligibility for, and the amount of, SSI payments.

Although the eligibility requirements in the regulations and program guidelines for other public benefit programs may be similar to those for SSI, interpretations of the same language by the various administrative agencies may vary dramatically. Thus counsel for an elderly homeowner considering home equity conversion should contact the local or district offices of pertinent agencies to determine their positions on the particular transaction in question.

Sales of Remainders

As noted previously, current SSI regulations treat the proceeds received from the sale of a home not as income, but rather as a converted resource. If a homeowner sells a remainder interest, i.e., a portion of the ownership interest in the home, it too should be treated as a converted resource. Since the homeowner has not sold the fee interest, the homeowner is not in a position to invest the proceeds of the sale in a new home within three months. Therefore, the cash received from the transaction should be treated by SSA as a converted resource. If the cash is not spent by the end of the month of receipt, it will presumably be counted against the applicable resource maximums in determining continued eligibility for SSI benefits.

This conclusion was confirmed by SSA recently in a letter commenting on certain aspects of a home equity conversion program involving the sale of a remainder.[44] The same letter also stated that the payment of maintenance and property taxes has no effect on SSI eligibility. This is based on the premise that payment of maintenance, property taxes, and fire and liability insurance is not income, but a conversion of a resource. Further, these items are not countable resources since nothing is retained into the following month that the SSI recipient could convert to cash to meet food, clothing, and shelter needs.

Food, clothing, and shelter are addressed specifically in the regulations with "support and maintenance in-kind"[45] (20 C.F.R. §416.1121(h)). Support and maintenance in-kind is considered a form of unearned income. It is defined as:

> any food, clothing, or shelter that is given to you or that you receive because someone else pays for it. Shelter includes room, rent, mortgage payments, real property taxes, heating fuel, gas, electricity, water, sewerage, and garbage collection services.[46]

As noted above, SSA has informally determined that payment of maintenance, property taxes, and fire and liability insurance (as found in the two plans currently offering sales of remainders) is not in-kind support and maintenance.

Home energy assistance is another service provided by both programs discussed previously that transact sales or remainders. Such assistance might count as in-kind support and maintenance under certain circumstances.[47] However, weatherization assistance (e.g., insulation, storm doors and windows) explicitly is not income in-kind.[48]

SSA's position on the above issues[49] should be viewed as SSA's current informal policy on those issues, and should not be exclusively relied on. SSA may change its informal posture without notice, or a more formal position could be announced through proposed regulations. Thus attorneys should acquaint themselves with the latest revisions in both SSI regulations and the program circulars prior to advising clients regarding this or any other equity conversion option.

Because payments received from home equity conversions are a nontraditional form of income, current SSI income and resource eligibility regulations do not adequately address them, at least not explicitly. However, since the SSI program aims to provide a minimum level of income to meet very basic needs, SSA can be expected to look very closely at any income-producing transactions which enable the recipient to continue to receive benefits.

Alternatives

Before making a decision about home equity conversion, an elderly homeowner should carefully consider all of the alternatives available to him or her.

A common solution for elderly persons who can no longer afford to live in their homes comfortably is to sell the home and move into other accommodations. This is, in a sense, the most common form of home equity conversion. The decision to sell and move elsewhere entails most of the same financial planning considerations discussed at length here in connection with the less traditional forms of home equity conversion (which permit the seller to remain in the home). Yet it is a step often taken by elderly homeowners without benefit of professional counseling or financial planning. In determining whether any form of home equity conversion (including an outright sale) is advantageous for a given individual, the cost and availability of alternative living arrangements (including an escalated cost over time) and investment and conservation of capital should be seriously considered.

A less drastic solution than selling their home that has worked for many elderly persons is to supplement their income by taking one or more roomers into the home. This can have both social and economic benefits. Some social service agencies now provide the services of "matching" roomers and available homes. The roomers are often students, but may also be other elderly persons. Local zoning restrictions must, of course, be taken into account.

A related alternative is to construct a separate rental unit in part of the home to supplement the homeowner's income. However, the cost of such a conversion may be prohibitive. To work, the rent obtained from the rental unit must be adequate not only to service the construction loan, but to provide a positive cash flow to the homeowner. Again, zoning restrictions would also have to be considered.

Finally, a number of states have enacted some form of property tax relief for senior citizens.[50] Many eligible homeowners may be unaware that their property taxes can be forgiven or deferred. Taking advantage of this could make an appreciable difference in the homeowner's available income.

Footnotes

[1]See generally B. Jacobs, "The National Potential of Home Equity Conversion," *The Gerontologist* (forthcoming). See also K. Scholen and Y. Chen, eds., *Unlocking Home Equity for the Elderly* (Cambridge, MA: Ballinger Publications, 1980); and *Home-Made Pension Plans; Converting Home Equity into Retirement Income* (Madison, WI: National Center for Home Equity Conversion, September 1984); and B. Jacobs, *The National Potential of Home Equity Conversion* (University of Rochester Public Policy Analysis Program, 1985). According to these sources, over 13 million homes are owned by persons age 65 or older; of these, 83 percent are owned debt-free. Nationwide, the elderly have over $700 billion in equity in their homes.

[2]Home equity conversion loans are not the same as "home equity loans" and lines of credit secured by home equity. Home equity loans generally require the borrower to make monthly installment repayments to the lender over the loan term, rather than providing monthly advances to the borrower over a period of years. Most elderly homeowners would not be eligible for home equity loans because their retirement incomes would be insufficient to carry the monthly debt service. For a discussion of home equity conversion loans, see section three, "Reverse Mortgage Loans."

[3]The American Bar Association's Commission on Legal Problems of the Elderly has published a booklet, *An Attorney's Guide to Home Equity Conversion*. It is available at no charge from Commission on Legal Problems of the Elderly, American Bar Association, 1800 M Street, N.W., Washington, DC 20036.

[4]An "unlimited" term is not a necessary feature of a shared-appreciation reverse mortgage loan, nor are unlimited advances to the borrower a necessary feature of an unlimited-term reverse mortgage loan. However, because these two kinds of reverse mortgage loans are the only kinds available, this discussion is limited to loans with these features.

[5]Some states prohibit compounding of interest; in other states, compound interest may violate usury limitations. Several solutions may be available to lenders wishing to offer reverse mortgages in these states, although solutions will have to be evaluated on a state-by-state basis. One solution may be to have the lender "advance" the interest to the borrower each month, and to have the borrower repay it each month. However, if the advance is structured so as to assure that the interest advance is repaid, this approach may be discounted as a form-over-substance approach. Another solution may be to lobby for state legislation specifically authorizing reverse mortgages. Some states have had such legislation in effect for a number of years. This is not discussed here, in part because these state laws are undergoing major changes. Finally, another solution may be to rely on the federal preemption of state laws restricting alternative mortgage loans in Title VIII of the Garn-St. Germain Depository Institutions Act of 1982 and the regulations issued thereunder, where and to the extent applicable. See 12 U.S.C.A., Section 3801 *et seq.*; 12 C.F.R. Part 545, Appendix, Section 545.32-33. For a brief discussion of the extent of the preemption, see Ronald Friend, "Shared Appreciation Mortgages," *Hastings Law Journal 34* (1982):331, 376.

[6]The shared-appreciation reverse mortgage loan is the only variable-rate reverse mortgage loans that have been available to our knowledge. Some variable-rate reverse mortgage loans could prove hazardous for the borrower by using up home equity more quickly than planned, and should be used cautiously.

[7]With respect to federal law regarding due-on-sale clauses, with specific reference to reverse mortgages, see 12 U.S.C.A. Section 1701j-3; 12 C.F.R. Part 591.

[8]See 12 C.F.R. Part 545.

[9]This may affect the availability of property tax deferrals available to senior citizens in some states. Many states have enacted some form of property tax relief for the elderly. While some states have set a cap on taxes, others defer payment until sale of the property, securing payment by a lien on the property. The borrower's counsel could request that a deferred property tax lien be subordinated to the reverse mortgage and that the reverse mortgage lender permit such a junior lien. If property tax deferral is a benefit that must be foregone in order to take out a reverse mortgage, the cost to the borrower (if not to the borrower's estate) will be significantly increased.

[10]For more information on reverse shared-appreciation mortgages, see "A Financial Guide to the Century Plan" available for $10.00 from National Center for Home Equity Conversion, 110 East Main St., Madison, WI 53703.

[11]Parts of this chapter are adapted with permission from *Sale-Leaseback Guide and Model Documents*, an 80-page publication available from the National Center for Home Equity Conversion, 110 East Main St., Madison, WI 53703.

[12]Internal Revenue Code (hereinafter "I.R.C.") Section 483. All citations to the Internal Revenue Code are to the Internal Revenue Code of 1954, as amended as of July 31, 1986.

[13]Enforceability of due-on-sale clauses has in the past varied from state to state. Although the statute is fairly new and has not been tested or interpreted by judicial decisions, such clauses now appear to be uniformly enforceable by virtue of federal preemption to the extent that they come within the terms of 12 U.S.C.A. Section 1703-j. For regulations applicable to individuals as lenders (among others), see 12 C.F.R. Part 591.

[14]For an excellent discussion of the issues confronting a sale-leaseback transaction, albeit written prior to the Tax Reform Act of 1984, see Homburger, Nations, Dowdall, Dressler, "Unresolved Questions in Sale-Leaseback Transactions: A Look at Real Estate, Tax and Bankruptcy Law Issues," *A.B.A. Real Prop., Prob. & Tr. J.* 19 (1984): 941, especially the tax discussion and the authority cited therein (hereinafter, "Sale-Leaseback Transactions").

[15]See the discussion of interest rates in "Method of Payment" above.

[16]See Cohen v. Ratinoff, 147 Cal. App. 3d 321, 195 Cal. Rptr. 84 (1983); and Schweiso v. Williams, 150 Cal. App. 3d 833, 198 Cal. Rptr,. 238 (1984). It may be impossible to protect a landlord from the effect of such rulings.

[17]See footnote 11.

[18]See I.R.C. Section 121. Section 121 also requires that the taxpayer must have attained the age of 55 before the date of the sale, and must have used the property as a principal residence for an aggregate of at least 3 of the 5 years preceeding the date of the sale (I.R.C. Section 121 (a)). The amount of gain excluded from gross income cannot exceed $125,000 in the case of a joint return (I.R.C. Section 121 (b)).

[19]For a brief discussion of a landlord's bankruptcy, see "Sale-Leaseback Transactions," note 127 at p. 979.

[20]26 C.F.R. Section 20.2031-7.

[21]One program does not offer a full lump-sum payment, but participants may elect to receive up to 25% of the purchase price in a lump sum with commensurately reduced monthly payments.

[22]See footnote 5.

[23]Internal Revenue Service Letter Ruling #8029088.

[24]See footnote 18.

[25]I.R.C. Section 167(h); Rev. Rul. 77-413, 1977-2 C.B. 298.

[26]States have several options in setting eligibility requirements for Medicaid. Basically, states may choose to base Medicaid eligibility on eligibility for federal SSI benefits or they may adopt more restrictive eligibility requirements. The former are called "SSI states," while the latter are known as "Section 209 (b)" states (after Pub. L. 92-603, Section 209 (b), 86 Stat. 1329, 1465 (1973)). The 14 Section 209 (b) states presently are Connecticut, Hawaii, Illinois, Indiana, Minnesota, Missouri, Nebraska, New Hampshire, North Carolina, North Dakota, Ohio, Oklahoma, Utah, and Virginia. For a general overview of Medicaid, which discusses these differences, see *Representing Older Persons: An Advocates Manual*, ed. B. Fried (Washington, D.C.: National Senior Citizens Law Center, 1985).

[27]*Representing Older Persons* p. 23.

[28]20 C.F.R. § 416.1205(c)

[29]Older Americans Act, Title III, 42 U.S.C.A. Section 3001 *et seq.*; 45 C.F.R. Section 1321.

[30]For a recent compilation of available resources for the elderly in the 50 states, see *The Law and Aging Resource Guide*, (American Bar Association Commission on Legal Problems of the Elderly, July 1985). A profile of available resources for any particular state will be provided free of charge upon request to ABA, C.L.P.E., 1800 M St., NW, Washington, DC 20036.

[31]20 C.F.R. 416.1103(f)

[32]This document focuses entirely upon how various home equity conversion methods affect SSI eligibility.

[33]20 C.F.R. §§ 416.1210(a) and 20 C.F.R. §§ 416.1212(a) (2)

[34]20 C.F.R. §§ 416.1201

[35]20 C.F.R. §§ 416.1103

[36]20 C.F.R. §§ 416.1212(d)

[37]20 C.F.R. § 416.1121(c)

[38]20 C.F.R. § 416.1103(f)

[39]20 C.F.R. § 416.1201(b)

[40]20 C.F.R. § 416.1201(c)

[41]20 C.F.R. § 416.1201(a)

[42]In-kind support and maintenance are discussed further in the following discussion of sale of remainders.

[43]20 C.F.R. § 416.1121(c)

[44]Letter from Martha A. McSteen, Acting Commissioner of Social Security, to Bill Clinton, Governor of Arkansas, December 19, 1985.

[45]20 C.F.R. § 416.1121(h)

[46]20 C.F.R. § 416.1130

[47]20 C.F.R. § 416.1155 and § 416.1156

[48]20 C.F.R. § 416.1103(i)

[49]See footnote 44.

[50]See footnote 9.

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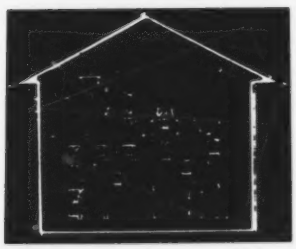

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